

1 Switching Systems

The break-up of the command system in the economies of Central Europe and the following disintegration of the former Soviet empire have brought unprecedented changes to nations in Central and Eastern Europe. The Czech Republic embarked on an uneasy path of reform from plan to market in 1990 and even at such an early stage it became clear that switching regimes would entail more than a single reform. It is more precise, then, to speak of regime transformation as consisting of several reforms executed in a parallel or subsequent fashion, often determined by political rather than economic forces. Initial conditions have co-determined the reform path taken in years following the break-up of the command system. Complexity of the reform process itself has involved a strong path-dependency of outcomes as well as various steps complementing major reforms that were taken later on as the transformation progressed. The following account will review initial conditions prior to break-up as well as those that formed at the beginning of the transformation. Then, major reforms will be assessed.

1.1 Initial Conditions

In 1989 the former Czechoslovakia had one of the smallest private sectors in the communist world, employing only about 1.2% of the labor force and producing a negligible fraction of the national output. Since 1948 the country had evolved in the cocoon of a command system. Moreover, since the government had followed a hard-line socialist approach, no real attempt to reform the economy or question its underlying political system occurred prior to 1989. Within five-year plans quantity was preferred to quality, and stress was put on the production of machinery while consumer goods and services were in shortage and of low quality. Specialization within the former Soviet bloc was on heavy industry, for which the Czech economy did not possess any comparative advantage. Information flow in the economy had been persistently devastated by administratively set prices that conveyed very limited information about cost structure. Over-employment was part of the command system and effectively
meant a waste of human resources. Due to the above pre-conditions, self-reliance among the population was extremely low and economic structures over-centralized.

Nevertheless, in comparison with other Central European countries on the eve of transformation, the Czech Republic stood at a relatively “good” starting position with no significant external debt, low inflation, positive trade balance, balanced government budget, and a great political will to liberalize the economy. On the other hand, because the country had a non-competitive economic structure, investments into technologies and infrastructure were necessary. Thus, the country had only very limited internal resources for financing the transformation.

Prior to launching the reform process the government adopted the so-called macroeconomic stabilization package. At this stage of transformation, the political economy of reforms advocated the appropriateness of such a step. The most important components were to restore price relations by liberalizing prices as well as the exchange rate, and to restore economic incentives including trade liberalization and subsequent removal of the controls on capital flows. After prices were liberalized inflation was successfully curtailed thanks to the firm policy of the newly created independent central bank.

Following stabilization, the transformation reforms were launched. The reform of utmost importance was to increase the share of private ownership (state ownership is connected with low efficiency) via privatization and support for small and medium enterprises. Creation of the proper institutional and legal framework that would support entrepreneurial activities and smooth the transition from the command towards the market was to complement the transformation process as a non-economic reform, albeit an extremely important one.¹

¹ Švejnar (1995) provides the first in-depth comparative analysis of the early stage of Czech economic transformation.
1.2 Economic Policies and Outcomes in Early Transition

The Czech Republic has awed observers of transition economies since within three years of the fall of communism, the government liberalized nearly all prices, privatized much of the economy, decentralized the wage setting, and opened the country to world trade while maintaining a relatively balanced budget, low inflation, and low unemployment (below 4% until 1995). The Czech GDP per capita level of over five thousand USD, with PPP adjustment factor of about two, was (and remains) high in comparison to other transition countries. Furthermore, in early transition, the economy appeared to be on an accelerating growth trajectory. By 1995, the initial recession and the negative impact of the split of Czechoslovakia had ended and the economy grew by almost 6%. In 1996, the economy recorded continuing robust growth of 5%, but by 1997 it was becoming increasingly clear that the macroeconomic success was not based on solid microeconomic foundations (see Figure 1.1 below and Figure A1.1 in the Appendix).

Figure 1.1: Real GDP Development

Note: For 1989-1994 constant prices of 1994 were used. For 1995-2003 constant prices of 1995 were used.

Source: Czech Statistical Office, Czech National Bank
Weak corporate governance allowed wages to grow two times faster than productivity, which led to a higher demand for imports of consumer durables and increasing foreign trade and current account deficits. These were financed by an inflow of short-term foreign capital attracted by high interest rates, themselves locked in by the fixed exchange rate regime.

Eventually, however, the implicit liabilities of soft loans to large old firms became explicit and the worsening performance of the economy led to an increase of the public budget deficit. Shortly after the current account deficit ballooned to 7.4% of GDP in 1996 (see Figure A1.2 in the Appendix), the imbalances – both internal and external – were noticed by capital markets and led to an attack on the Czech currency in May 1997. The attack forced the surrender of the fixed exchange rate regime and the crown depreciated by approximately 10%. The Czech National Bank (ČNB) used high interest rates to stabilize the currency while also strengthening provisioning requirements, which led to a credit crunch. Meanwhile, the government was forced to implement a strict austerity program. All of this sent the economy deep into recession.

The recession was prolonged, with GDP in red numbers for three consecutive years while other Visegrad countries enjoyed substantial growth. Registered unemployment rose from about 4% in 1996 to 8.5% in 1999 (see Figure 1.2) and wage growth slowed down hand in hand with government spending. The recession was driven by a decline in both private spending and investments, while net exports were mostly improving the overall picture – thanks also to the weaker currency.
The downturn shattered the illusion of successful reforms and contributed to the fall of the long-serving coalition government headed by Václav Klaus' Civic Democrats and to the resulting early elections of 1998. Further, following party finance scandals, a significant number of Civic Democrats established a new liberal right-center party. The early elections of 1998 were won by Social Democrats, who were, however, unable to form a majority coalition. Personal animosity among the leaders of the former right-center coalition partners blocked their majority coalition. Only the so-called “opposition agreement” between the Social and Civic Democrats opened a way out of the deadlock. The Civic Democrats committed themselves to tolerating a minority one-party government of ČSSD in exchange for a dominant role in the Lower and Upper Houses and for participation in the sale of remaining large state firms.

In 2000 the two main parties introduced a set of controversial laws and constitutional changes that would limit the president’s power as well as the independence of the national bank and that would alter the electoral system in favor of large parties. These attempts to change the rules of the Czech political

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**Figure 1.2: Unemployment Rate Development**

Source: Czech Statistical Office
game failed due to actions taken by the Upper Chamber of the Parliament (Senate) and the Constitutional Court.

1.3 Economic Development on the Eve of the Millennium

Starting in 1998, the strict monetary policy born of the currency crisis was relaxed by the central bank. Facing a recession, the new government revived structural reform and privatization, this time relying on strategic foreign partners. Clearly, the government’s decision was strongly path-dependent. Further, in April 1998 the government introduced an aggressive foreign direct investment (FDI) incentive package for manufacturing investors, which brought in more than USD 10 bn. Even so, 1999 GDP remained in red numbers.

Finally, in 2000 the economy took off. Investments started to grow, primarily due to the surge of FDIs, but domestic firms started to invest more as well. FDI inflow continued at similar strength during 2001, thanks to both the incentive package and the expected accession of the Czech Republic into the EU. Moreover, private consumption also accelerated (fueled by real wage growth that reached 4% during 2001). While GDP statistics do not reveal fast growth of public spending, part of the government spending is of course hidden in the private demand and investment components. Overall, GDP growth stood at over 3% in 2000 and 2001.

The only macroeconomic variable to exhibit mixed performance was net export. The 1997-99 recession helped limit imports and thus also the foreign trade deficit, the main cause of external imbalance, from almost CZK 160 bn. in 1996 to just above CZK 60 bn. in 1999. Yet, when the economy started to grow in 2000 the deficit doubled again and continued to widen (see Figure 1.3). It should be noted, however, that not all of the increase was attributable to the revival of economic growth. Higher prices of oil and other raw materials were significant factors behind growing imports, as the Czech economy is to a large extent dependent on imported raw materials. Further, it was often the case that foreign investors imported the major part of technology when investing in the country. Finally and most importantly, the economic slowdown in the EU also
limited the growth of exports, as the EU is by far the largest trading partner of the Czech Republic.

Figure 1.3: Development of Exports and Imports

Still, the current account appeared worrisome, reminding one of the 1997 crisis. The deficit narrowed from above 6% of GDP in 1997 to around 3% in 1998 and 1999, but the year 2000 saw it worsen to just below 5% of GDP—a trend which continued through 2001. The key difference from the 1997 situation, however, was in the financing of the current account deficit. While it was unstable short-term capital which financed the current account deficit prior to the 1997 crisis, the recent current deficit was financed by direct investments, which are long-term in nature. The inflow of FDI (as a share of GDP) was four times higher than in 1996-97 and appeared capable of safely financing the current account deficit.

The one macroeconomic variable that has been under control throughout the entire Czech transition is inflation. Low domestic demand during the 1997-
99 recession, combined with a relatively strict monetary policy and low commodity prices, reduced the average inflation rate to 2.1% in 1999. It also helped that the government froze the upward adjustment of regulated prices of housing and utilities. Later, the revival of domestic demand, higher commodity prices (mainly oil) and several idiosyncratic factors worked to increase inflation, which reached the 4% mark by 2000. Interest rates followed the decline of inflation with a time lag, as did the central bank in its setting of official rates. Thus, in contrast to most of the 1997-99 period, real interest rates have recently been quite low.

As the recession came to an end, the exchange rate regained strength and remained relatively stable during 2000-2001. A strong currency combined with low real interest rates and the limited growth of bank lending resulted in a neutral to relaxed overall monetary policy. Recently, however, the privatization of banks and the planned privatization of the Czech telecom and utility monopolies have led to an unhealthy rise in the value of the crown.

From the perspective of the political economy of transformation, conceivably the main macroeconomic concern is the high and growing public finance deficit. The deficit only partly stems from temporary issues. Netting out extraordinary budget items including privatization receipts and the costs of bank restructuring, the overall balance of the general government mushroomed to 4.8% of GDP in 2000 and grew further in 2001. Excluding extraordinary items, the entire 2001 deficit reached an incredible 9% of GDP. The concurrent economic recovery made clear that the deficit was not merely cyclical. Since fiscal revenue of the Czech government is already high as a fraction of GDP, the adjustment must come on the expenditure side. Yet, most categories of expenditure (including social welfare, housing, and transport) are locked in upward trajectories, even though maintenance activities have already been severely restricted in recent years. Between 1994 and 1999, social security and welfare expenditures rose by 3.2% of GDP. Public expenditure on social welfare persistently exceeded payroll revenues and the deficit was projected to grow even during the expected years of economic expansion. These deficits occurred while the demographic situation had not yet deteriorated; however, the
demographic situation is expected to worsen towards the end of the new decade. If there is no change in fiscal policy, the current debt of the country will increase from 20% to almost 42% of GDP between now and 2006 and reach the magic 60% of GDP before 2010.

In sum, after 1999, the Czech economy successfully emerged from recession with GDP growth rates around 3%. The recovery was driven by private investments, primarily FDI, which also financed the widening trade deficit. While inflation was low, real wage growth resumed after the recession and was in line with productivity growth. Unemployment stayed in the neighborhood of 9%.

1.4 Recent Economic Positions

At the end of the first decade of transition, Czech economic growth depended on (sluggish) EU performance, but a crisis similar to 1997 is unlikely if wage demands are curtailed in the face of a substantial slowdown. Unfortunately, the external imbalance is again coupled with internal ones. The sorest part of the Czech economy is its fiscal deficit. The general government deficit reached the neighborhood of 9% of GDP and began to represent alarming evidence of needed reforms in the public finance system. The looming aging of the population makes the fiscal outlook even more distressing.

Among other outstanding policy challenges (also voiced in the annual pre-accession EU reports) are the inefficiency of public administration, a much-needed reform of the judicial system, the insufficient use of public tenders by the government, and the taming of corruption.

Despite global economic slowdown, the Czech Republic has experienced moderate economic growth compared to the rest of the world. The 2003 GDP growth was a robust 2.9%, which is a moderate improvement from the 2.0% of 2002 and no significant change from the 3.1% of 2001 (see Figure 1.1 above or Figure A1.1 in the Appendix). The unfavorable unemployment trend has not reversed, notwithstanding moderate growth, and the absolute level has slightly risen (see Figure 1.2 above). Although in previous years the level of
unemployment stagnated with end-of-year rates slightly below 9%. 2002 brought the figure to 9.9% and 2003 ended up at 10.9%. The significant FDI inflow of the past has continued, although the record level of USD 9 bn. the Czech economy received in 2002 will likely not be matched in the future, as there was no significant privatization in 2003; the figure was USD 2.6 bn. Continuous massive long-term capital inflow has kept the Czech currency under appreciation pressures in the past, and the FDI slowdown has not been not significant enough to change the situation. To complete the picture, inflation fell too and in 2003 was only 0.1%; in 2004 it is expected to remain low but reflect tax and other fiscal changes that are related to EU entry in 2004 (ČNB expects an inflation rate between 2.6% and 4%).

However, these moderately positive signals cannot be correctly interpreted without taking note of the continuing expansionist fiscal policy of the government. The price of the moderate growth is high: the increase in the deficit of public finances is drastic. The public finance deficit was 6.7% of GDP in 2002 and the year 2003 is expected to be close to CZK 135 bn. (about 8% of GDP). The state budget accepted for 2004 brings no real improvement (the state deficit was approved at a high of CZK 111 bn.) and public finances will remain in huge deficit for the next several years. The government prepared – at most – moderate fiscal reform but during the course of the year the real reform steps were softened and postponed even further.

1.5 EU Accession

The Czech Republic held a referendum on EU Accession on June 13th and 14th 2003. The cast vote in favor of accession was 77.3% with the electorate turnout just above 55%. The European Commission’s last pre-accession annual report on the Czech Republic was favorable. It should be noted that the Czech Republic has reached alignment with the acquis in most policy areas, though with several concerns expressed. Entering into the EU will involve a commitment to adhering to the Growth and Stability Pact, with which the current fiscal policy would probably be in violation. The continued deterioration of the general government deficit, therefore, has led the government to
undertake steps towards the consolidation of its public finances and to present a set of measures aimed at bringing the deficit down to 4% by 2006.

The accession process still has several administrative obstacles to overcome, although these are not very significant. Concerns in the area of free movement of persons relate to the Czech Republic’s readiness for mutual recognition of university diplomas and other professional qualifications, as the necessary regulation has not been enacted yet. In the field of agriculture, there is need for progress in the upgrading of agri-food establishments in order to meet public health requirements. Finally, implementation of the social and technical acquis should be reinforced in the field of road transport.

1.6 Privatization

The privatization program in the Czech Republic was carried out in the first half of the 1990s under three different schemes: restitution, small-scale privatization, and large-scale privatization. The first two schemes started in 1990 and were important during the early years of the transition. Large-scale privatization, by far the most important scheme, began in 1991 and was completed in early 1995. The privatization program allowed for various privatization techniques. Small firms were usually auctioned or sold in tenders. Many medium businesses were sold in tenders or to pre-determined buyers in direct sales. Most large and many medium firms were transformed into joint stock companies whose shares were distributed through voucher privatization (almost one-half of the total number of all shares of all joint stock companies were privatized in the voucher scheme), sold in public auctions or to strategic partners, or transferred to municipalities. Re-privatization as well as bail-outs that were undertaken during the second half of the 1990s were strongly path-

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2 The privatization process has been extensively described and analyzed. See e.g., Švejnar and Singer (1994), Kotrba (1995), Coffee (1996), and Kočenda (1999).

3 A theoretical analysis and overview of privatization and firm performance in transition is provided by Roland (2000). A comprehensive overview of privatization effects on firm performance can be drawn from Bevan, Estrin and Schaffer (1999), Sachs, Zinnes and Eilat (2000), Shirley and Walsh (2000), Megginson and Netter (2001), and Djankov and Murrell (2002); to an extent results are inconsistent, though.
dependent on how the privatization was carried out and on the post-privatization behavior of the government.\textsuperscript{4}

The voucher scheme was part of the large-scale privatization process and attracted considerable interest and publicity. Two waves of voucher privatization took place in 1992-93 and 1993-94, respectively. The early post-privatization ownership structure emerged as shares from the second wave were distributed in early 1995. Rapid reallocation of shares across new owners took place in 1995-96 during the so-called "third wave" of privatization as new owners, including the privatization investment funds (PIFs), reshaped their initial post-privatization portfolios of acquired companies. Depending on the investor, the swapping of shares in 1995-96 was aimed at (a) optimal portfolio diversification, (b) obtaining concentrated ownership in specific firms and industries and (c) achieving conformity with legal requirements aimed at preventing excessive stakes being held by privatization funds.\textsuperscript{5}

The 1995-96 ownership changes were massive, unregulated and frequently unobservable to outsiders. Investors, especially the PIFs, engaged in direct swaps of large blocks of shares, and off-market share trading was common. More stable and, from the standpoint of firm performance, more meaningful patterns of ownership emerged in 1996.\textsuperscript{6}

The main reasons for using mass privatization to the hands of domestic owners were political. As there was enormous lack of domestic capital, selling the state-owned productive assets to those who were willing to bid the highest price would have meant massive inflow of foreign capital. However, the sale of the “national silver” to foreigners was hardly politically acceptable and such an

\textsuperscript{4} More on this issue in the next section.
\textsuperscript{5} The regulation of PIFs evolved gradually through Decree no. 383/1991, its Amendment No. 62/1992, and Act No. 248/1992. The most important clauses restricted each privatization fund from investing more than 10% of points acquired in the voucher scheme in a single company and obtaining in exchange more than 20% of shares in any company. Privatization funds established by a single founder were allowed to accumulate up to 40% of shares in a given company, but this cap was later reduced to 20%. Many privatization funds circumvented the cap through mergers. The Act also prohibited PIFs founded by financial institutions from purchasing shares of other financial institutions to prevent excessive concentration of financial capital (for details see Kotrba and Švejnar, 1994).
\textsuperscript{6} For an analysis of changes in ownership structure see Kočenda and Valachy (2002).
approach to privatization was believed to be political suicide for the reformers. The Czech Republic and Russia were the pioneers in implementing the voucher method in mass privatization and throughout the 1990s many other transition economies followed these examples in various forms. In some of these countries, especially FSU countries, the political unacceptability of the alternative way was combined with the low willingness of foreign investors to enter these risky markets. All in all there were only three transition countries which dared to use predominantly standard methods to privatize state enterprises to foreigners: Estonia, East Germany, and Hungary. Now, when the economic advantages of using these standard methods have been proved, it would be rather simplistic to say that the Czech Republic should have done this, too. There were strong country-specific factors that affected the choice made by Estonian, German, and Hungarian reformers but did not appear in the Czech, or then Czechoslovak, context. For East Germany it was re-unification with its western brother. In Hungary, a huge foreign debt inherited from socialism forced the reformers to maximize privatization revenues; this argument in the end eclipsed any political undesirability the standard way might have engendered.

In the Czech Republic, mass privatization followed a tacit doctrine of economic nationalism, as most property was transferred to local owners either by offering loans to local buyers or through the voucher scheme. Privatization failed, however, to generate sound corporate governance and often resulted in incestuous ownership relations. Large banks remained under government control in order to “fuel” transition with credit while bankruptcy and foreclosure laws were weak, making room for lax financial discipline. As a result, while the economy was growing, banks were accumulating non-performing loans at a distressing rate. While both Hungary and Poland lowered their share of non-performing loans from about 28% in 1994 to less than 10% in 1998, the Czech share stood at 33% in 1998, comparable to that of Romania.

The local owners of privatized firms were indebted from the start and lacked the managerial capital to restructure and operate firms, which faced fierce international competition due to a high degree of openness. Easy access to
bank credit coupled with a weak legal and impotent judicial system resulted in massive asset stripping (tunneling) of privatized enterprises.

Yet privatization was not the only method of creating private sector output. Throughout the early transition period new (de novo) private firms were also being created. While early on credit to small firms may have been generous, retained profit was a major determinant of new investment. Small firms were apparently the force behind low Czech unemployment. Survey evidence suggests that small new private firms were responsible for almost all of the vigorous Czech job creation during early reforms, such that five years into transition de novo firms offered more jobs than both the state and privatized firms combined.

The outcome of the voucher privatization may be measured in various ways. The two most important ones are (1) the degree of efficiency at which the property was allocated from state to private owners and (2) the effects of privatization on corporate performance of privatized firms.\(^7\)

**1.6.1 Efficiency of Privatization as Allocation Process**

Voucher privatization in the Czech Republic was remarkably successful in allocating shares of targeted state enterprises quickly and efficiently. The bidding process was crude in many ways, especially in the administration of share prices and in the attempts by the privatization authority to artificially speed up the process by over-adjusting prices, but in spite of the artificial price jolts, the market reacted logically, even predictably. In five or six short rounds over a few months almost all shares were allocated and nearly all voucher points were spent. Individual investors, taking their cues from the PIFs (to whom they attributed better information), tried to get the most value for their vouchers. But these individuals paid less attention to the PIFs in the second wave than in the

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\(^7\) Few would doubt that the economic performance of planned economies was disastrous and that state ownership of firms was in part to blame. This belief motivated large-scale privatizations across Central and Eastern Europe. However, there is surprisingly little convincing evidence that the privatized firms did indeed perform better, despite a large number of papers written on this topic. Actually, some of the fastest growing transition economies in the 1990s (e.g., China, Poland and Slovenia) were among the slowest to privatize.
first, indicating growing investor self-confidence. The PIFs, guided by considerations other than short-term portfolio maximization, tried to acquire shares even at premium prices.\(^8\)

The openly public way that shares were transferred from the state to private hands ensured that no individual or group of investors could reap windfall gains at the expense of the general populace. The experience convinced many skeptics that even in a country unaccustomed to free enterprise, the market is a powerful force that can be more equitable than other paternalistic restitutions.

A corroborating set of findings can be drawn from the ability of prices to adjust between successive privatization rounds.\(^9\) For the larger firms comprising the bulk of assets involved in the scheme, prices rapidly incorporated all the information available in public data. Even more strikingly, although there was substantial private information about which firms were most valuable at the start of the process, this information was also rapidly incorporated into prices. After approximately two price adjustments based on excess demand, even the most informed insiders no longer possessed private information about firms’ future value beyond what could be inferred from the voucher prices of the shares in these firms. These results strongly support the ability of prices to adjust quickly in response to excess demand or supply in order to reflect all available information.

### 1.6.2 Effect of Privatization on Corporate Performance

Whether privatization improves firm performance belongs among one of the fundamental and most controversial economic questions. It has been analyzed how changes in ownership structure affect the performance of those Czech medium and large firms that were privatized in the large-privatization scheme.\(^10\) The analysis has been performed on a complex panel dataset covering virtually the complete population of firms that went through large-scale privatization.

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\(^{8}\) Results are based on the analysis of Hanousek and Kroch (1998).
\(^{9}\) Results are based on the analysis of Filer and Hanousek (2001).
\(^{10}\) Results are based on the analysis of Hanousek, Kočenda, and Švejnar (2004).
privatization. The findings were complex. On the one hand, concentrated and private ownership was correlated with better economic performance, but only if the owners were foreign. On the other hand, domestic private ownership in many respects did not significantly improve performance over state ownership. Foreign firms apparently engage in strategic restructuring to increase profits and sales, whereas domestic owners on average seem to reduce sales and labor costs (defensive restructuring). Also, the presence of a large domestic stockholder may not result in superior performance if this shareholder “loots” the firm. A further effect on firm performance was found in cases when the Czech state remained present in some of the privatized firms by means of the so-called “golden share”. Existence of such a golden share prevents looting and has proved to be surprisingly efficient, suggesting that the state induces profit-oriented restructuring but also pursues the social objective of employment generation. The evidence gathered above supports the fact that the label “private ownership” should not be overestimated. What matters is not the label, but the real ownership structure. A firm improves its performance if a sufficiently powerful stakeholder (or alliance of stakeholders) exists and if this stakeholder has the motivation to push forward strategic restructuring.

11 Similar findings can be found in Kočenda and Valachy (2003), and Lízal and Švejnar (2002). Kočenda and Hanousek (2003) on the other hand analyzed the effect of privatization on corporate governance.